

IN THE UNITED STATES BANKRUPTCY COURT
FOR THE SOUTHERN DISTRICT OF ILLINOIS

IN RE:

FRANK E. O'DONNELL, SR. and)	In Proceedings
FRANK O'DONNELL ENTERPRISES,)	Under Chapter 7
)	
Debtor(s),)	No. BK 90-30174
)	
LANDMARK BANK OF ILLINOIS,)	Adv. No. 90-0122
successor to merger with)	
LANDMARK BANK OF FAIRVIEW)	
HEIGHTS, now known as)	
MAGNA BANK OF ST. CLAIR)	
COUNTY, N.A.,)	
)	
Plaintiff,)	
)	
VS.)	
)	
CHARLES STEGMAYER, JR., as)	
Successor Executor of the)	
Estate of FRANK E. O'DONNELL,)	
SR., Deceased,)	
)	
Defendant.)	

OPINION

Frank O'Donnell, Sr. (hereafter "debtor") had been a customer of Landmark Bank of Fairview Heights¹ since 1979. On June 8, 1987, he executed a promissory note to Landmark in the principal sum of \$119,170.27 (hereafter sometimes referred to as "first loan"). The note was secured by an assignment of the debtor's beneficial interest in a land trust valued at \$98,000. Under the terms of the note, the debtor was obligated to pay interest on a quarterly basis, with the first payment due on September 5, 1987, and the principal balance was

¹Landmark Bank of Illinois, now known as Magna Bank of St. Clair County, N.A., merged with and succeeded Landmark Bank of Fairview Heights. For the sake of convenience, hereafter all references to plaintiff shall be to "Landmark" or to "bank."

to be paid in full at maturity six months later on December 5, 1987. The debtor made an interest payment of \$2,983.39 on October 13, 1987 on the first loan.

When the note matured on December 5, 1987, the debtor made an interest payment of \$3,196.90 and Landmark renewed the note for another six months. Under the terms of the renewal note, the debtor was to make quarterly interest payments, with the first payment due on March 5, 1988, and all accrued interest and principal due and payable at maturity on June 5, 1988.² The debtor made an interest payment of \$3,216.77 on March 24, 1988 on the first loan.

On April 7, 1988, the debtor executed a second promissory note to Landmark in the principal amount of \$25,000 unsecured by any of the debtor's assets (hereafter sometimes referred to as "second loan"). According to its terms, the debtor was to make monthly interest payments on the note, with the first payment due on May 1, 1988, and the principal balance and any accrued interest were due at maturity a year later on April 1, 1989.

When the first loan matured on June 5, 1988, Landmark renewed the note for approximately three more years. Under the terms of the renewal note, the debtor was to make quarterly payments of principal and interest in the amount of \$3,578.46, with the first quarterly payment due on October 1, 1988. All unpaid principal and accrued interest were due and payable at maturity on July 1, 1991.

²On February 2, 1988, Landmark sent a letter to the debtor requesting that he provide a recent financial statement to satisfy the requirements of federal and state bank examiners. The record does not reflect whether the debtor submitted a financial statement in response to this letter.

On July 6, 1988, the debtor made interest payments of \$2,439.01 on the first loan and \$560.99 on the second loan. On July 12, 1988, the debtor made interest payments of \$800.11 on the first loan and \$237.72 on the second loan.

On December 14, 1988, Landmark prepared a letter to the debtor and his wife declaring both loans in default and advising the O'Donnells that all amounts owed on both loans were immediately due and payable. The record does not reflect whether this letter was ever mailed to the debtor.

On December 23, 1988, the debtor made interest payments of \$3,578.46 and \$1,019.45 on the first loan. On December 29, 1988, he made an interest payment of \$1,019.45 on the second loan. On February 27, 1989, he made an interest payment of \$3,578.46 on the first loan. And, on March 17, 1989, he made an interest payment of \$788.89 and a principal payment of \$211.11 on the second loan.

At some time before April 1, 1989, when the second loan was to mature, Charles Cashner, who was then Landmark's senior vice-president in charge of lending, contacted debtor for the purpose of obtaining current financial information from him. Due to debtor's reluctance to provide the financial information, Mr. Cashner scheduled an appointment with debtor at Landmark's offices on March 31, 1989. When debtor appeared at the appointed time, he and Mr. Cashner completed a financial statement for the debtor. Although the handwriting on the financial statement at issue is that of Mr. Cashner, and Mr. Cashner computed certain of the figures that appear on its face, he completed the form through discussion with the debtor about his financial condition and through review with the debtor of

the assets and liabilities he had listed on previous financial statements contained in his credit file at Landmark. After the debtor and Mr. Cashner reviewed the financial statement together at least two times, the debtor signed the document and, in so doing, warranted it to be true and complete. The financial statement indicated that debtor had a net worth totaling \$1,355,470. In fact, debtor's net worth was at most \$955,470 due to his failure to disclose at least \$400,000 in unsecured debt on the financial statement.³

When the second loan matured the next day, April 1, 1989, Landmark renewed the note to July 1, 1991, corresponding with the maturity date on the first loan. Under the terms of the renewal of the second loan, the debtor was to pay only interest for two months, followed by monthly payments of \$1,000 principal, plus interest, until maturity. At maturity, all unpaid principal and accrued interest was due and payable.

On April 5, 1989, the debtor made principal and interest payments totaling \$3,578.46 on the first loan and an interest payment of \$291.18 on the second loan. The debtor made interest payments of \$288.17 on May 2, 1989 and \$278.88 on June 30, 1989 on the second loan. On August 9, 1989, the debtor made principal and interest

³The parties stipulated in the pretrial order that the debtor failed to list unsecured debts totaling at least \$400,000 on the financial statement and that the debtor had a negative net worth at the time he executed the financial statement. However, the bank's counsel subsequently represented to the Court during a telephonic hearing that the only inaccuracy on the financial statement was the omission of at least \$400,000 in unsecured debt.

The parties also stipulated that the first loan was in default on March 31, 1989.

payments totaling \$3,578.46 on the first loan and \$1,270.27 on the second loan. On September 1, 1989, the debtor made principal and interest payments totaling \$1,277.49 on the second loan.

On March 20, 1990, the debtor filed a petition for relief under chapter 7 of the Bankruptcy Code, prompting the bank to file the cause of action before the Court today. The basis of the bank's cause of action under 11 U.S.C. section 523(a)(2)(B) is that the financial statement executed by the debtor on March 31, 1989 was materially false due to the debtor's omission of at least \$400,000 in unsecured debt from the financial statement and that the bank relied on the financial statement in "maintaining" the first loan and in renewing the second loan. The debtor died on November 16, 1990, and his testimony is not available to the Court.

The Court begins its analysis with certain fundamentals governing the plaintiff's burden in a dischargeability case. The plaintiff must establish that the debt is nondischargeable and has the burden on each element of its cause of action. In re Schmidt, 70 B.R. 634, 638 (Bankr. N.D. Ind. 1986) (citing In re Kreps, 700 F. 2d 372, 376 (7th Cir. 1983)). It must prove each element by a preponderance of the evidence. Grogan v. Garner, 498 U.S. 279, 286-91 (1991). Additionally, exceptions to dischargeability are to be narrowly construed in keeping with the Bankruptcy Code's policy of fostering a fresh start for the bankrupt. E.g., In re Schmidt, 70 B.R. at 638.

Section 523(a)(2)(B) of the Bankruptcy Code provides:

(a) A discharge under section 727 . . .
of this title does not discharge an individual
debtor from any debt--

. . . .
 (2) for money, property, services,
**or an extension, renewal, or refinancing of
 credit,** to the extent obtained by--

 (B) use of a statement in
 writing--
 (i) that is materially
 false;
 (ii) respecting the
 debtor's or an insider's financial condition;
 on which the creditor to whom the debtor is
 liable for such money, property, services, or
 credit reasonably relied; and
 (iv) that the debtor
 caused to be made or published with intent to
 deceive

11 U.S.C. §523(a)(2)(B) (emphasis added). Accordingly, in addition to the six elements that the bank must prove with respect to the financial statement itself,⁴ it must also show that the debtor obtained money, property, services, or an extension, renewal, or refinancing of credit using the financial statement. While it is clear that the debtor obtained a renewal of the second loan on April 1, 1989, the question of whether the debtor obtained an extension of credit with respect to the first loan is decidedly murky.

The bank renewed the first loan on June 5, 1988, for a period of approximately three years ending on July 1, 1991. When the debtor tendered the financial statement on March 31, 1989, the bank neither advanced new money, property or services to the debtor nor renewed or refinanced his existing loan. Thus, if the bank is to prevail as to the first loan, it must prove that its actions as to this loan

⁴The elements are: (1) the debtor made (2) with intent to deceive (3) a materially false (4) statement in writing (5) respecting the debtor's or an insider's financial condition (6) on which the creditor reasonably relied. E.g., In re Harasymiw, 895 F.2d 1170, 1172 (7th Cir. 1990).

constituted an extension of credit.

The Court has reviewed the two lines of authority respectively supporting or refuting the proposition that a creditor's forbearance from enforcing its collection rights is an extension of credit within the meaning of section 523(a)(2) of the Bankruptcy Code.⁵ See, e.g., In re Gerlach, 897 F. 2d 1048, 1050 (10th Cir. 1990); In re Chapman, No. 91-C6001, 1991 WL 247602, at *3-4 (N.D. Ill. Nov. 18, 1991); In re Cerar, 97 B.R. 447, 450-51 (C.D. Ill. 1989); In re Marx, 138 B.R. 633, 636 (Bankr. M.D. Fla. 1992); In re Hoffman, 80 B.R. at 926-27; In re Mancini, 77 B.R. 913, 915-16 (Bankr. M.D. Fla. 1987); In re Fields, 44 B.R. at 329; In re Eaton, 41 B.R. 800, 802-03 (Bankr. E.D. Wis. 1984) (all holding that forbearance does constitute an extension of credit within the meaning of section 523(a)(2)); In re Schmidt, 70 B.R. at 644-45; In re Bacher, 47 B.R. 825, 829 (Bankr. E.D. Pa. 1985) (both holding that forbearance does not constitute an extension of credit within the meaning of section 523(a)(2)). It finds persuasive that line of reasoning which holds that a creditor who has given up or deferred valuable collection rights has, in fact, extended credit. However, the Court also recognizes that it is a simple matter, when the course of events takes a different turn than had been hoped, for a creditor to relabel inaction or acquiescence as forbearance.

⁵An extension of credit within the meaning of section 523(a)(2) has been defined as "an indulgence by a creditor giving his debtor further time to pay an existing debt," In re Fields, 44 B.R. 322, 329 (Bankr. S.D. Fla. 1984) (quoting State v. Mestayer, 80 So. 891, 892 (La. 1919)), or "a lengthening of credit, i.e., a creditor's agreeing to forego the enforcement of a contractual right to collect on a debt for some defined or undefined period of time." In re Hoffman, 80 B.R. 924, 926-27 (Bankr. N.D. Ill. 1988) (citing Black's Law Dictionary 523 (5th ed. 1979)).

Accordingly, the Court will require proof of overt acts to support a creditor's claim that forbearance has occurred in exchange for tender of a financial statement.

In the instant case, the evidence reflects that in December, 1988, the bank may have considered accelerating and calling both loans, and that a letter of default was prepared by the bank on December 14, 1988. However, the record is unclear as to what happened next. Mr. Cashner testified as follows about the events in December, 1988:⁶

Question: All right. Now, did you ever consider calling Mr. O'Donnell's loans?

Answer: Yes.

Question: Did you ever call his loans?

Answer: I don't remember.

Question: Did you ever write him a default letter?

Answer: I don't remember.

Question: Let me hand you what has been marked as Defendant's Exhibit Number 7 (indicating) and ask you if that refreshes your recollection as to whether or not you ever wrote him a default letter.

Answer: This is unsigned so, it is unclear to me whether or not this was ever mailed or not. It appears that it was, because it has a certified mail receipt on it. However, it is an unsigned copy. I can't remember if that was mailed or not.

Question: Well, whether you agree that it was mailed or not, you certainly agree that you had it typed up to send out?

⁶Charles Cashner's deposition taken August 4, 1993 was admitted into evidence by agreement of the parties.

Answer: That's correct.

Question: And that was in December of 1988, is that right?

Answer: Yes.

Question: So, in December of 1988, you felt uncomfortable enough about Mr. O'Donnell's loan at least to prepare and have typed up a default letter and assign a certified mail return receipt requested slip?

Answer: Yes.

(Tr. at 65-66.) Thus, the Court is left to guess whether or not the bank had decided to accelerate and call the loan and, if the decision to accelerate was made, why the bank ultimately did not accelerate and call the loan. In any event, there is no evidence in the record linking the bank's decision to the debtor's tender of the financial statement some three months later.

In fact, the only evidence showing the bank abandoned collection efforts on the first loan is found in the following passages from Mr. Cashner's deposition:

Question: Did you advise or tell Frank O'Donnell that the bank was requiring a financial statement in order for him to maintain his loan with the bank?

Answer: Yes, I did.

Question: Or to consider renewing his loan with the bank?

Answer: Yes.

Question: You have indicated that Mr. O'Donnell had a series of delinquencies with the bank, and I believe that that was at the time he gave the financial statement which was marked as Exhibit Number 5. Did the bank have a plan of action to collect this debt at that time, or was the bank considering any collection action at the time that Frank

O'Donnell gave the financial statement marked as Exhibit Number 5 to the bank?

Answer: Frank O'Donnell had begun to establish a history of breaking promises with the bank. He was continuing to be delinquent on a regular basis on the first note, the larger note, for \$119,000. He had also failed to pay off the \$25,000 note within a 90 to 120-day period of time in which he had promised earlier. I was concerned about his continuing ability to eventually re-pay [sic] both of these debts.

Question: Did you advise Mr. O'Donnell that the bank was considering collection action?

Answer: Yes.

(Tr. at 10, 13-14.) The Court is troubled by the generality of these statements. Of course, bankers "consider" collection action as one of several alternatives whenever a loan is in default. However, the fact that this alternative is contemplated does not mean that the creditor has made the decision to proceed with collection. Here, the Court is unable to find that credit was extended to the debtor on the first loan in the absence of evidence showing that the creditor, after deciding upon or taking steps toward collection, either refrained, or agreed to refrain, from exercising those rights.

Moreover, the bank has failed to prove the element of reliance with respect to the first loan. The Court does not credit Mr. Cashner's testimony to the extent it suggests that the bank did not take collection action based on the false assurance it received from the debtor's financial statement. As noted above, Mr. Cashner testified at his deposition that, at the time the financial statement was tendered, the debtor "was continuing to be delinquent on a regular basis on the first note" (Tr. at 14.) However, the

record does not bear this out. Instead, the record reflects that when the first note was renewed for a second time on June 5, 1988, the terms of repayment were changed to require the debtor to pay the sum certain of \$3,578.46 each quarter, beginning on October 1, 1988, until maturity on July 1, 1991. Following the June 5, 1988 renewal, the debtor made payments on the first loan totaling \$3,239.12 in July, 1988; \$4,597.91 in December, 1988; \$3,578.46 in February, 1989; \$3,578.46 in April, 1989; and \$3,578.46 in August, 1989.⁷ Accordingly, rather than continuing to be delinquent on a regular basis, it appears that the debtor was paying essentially as promised at the time that the financial statement was tendered. The following passage from Mr. Cashner's deposition supports this proposition:

Question: Okay. What we are having a problem with when you say "more quickly" is -- I see a loan initiated in 1987 where the only thing that is ever paid on it is interest, except one big pop on principal. You say "more quickly." I don't understand what "more quickly" means when we say that. Aren't you really saying, sir, that what you wanted him to do was start making periodic principal payments on a regular basis?

Answer: Mr. O'Donnell was in a business that did not provide him with a steady stream of income like being a banker where I am paid every two weeks. He was a real estate developer and his income came in lump sums that were unpredictable. Mr. O'Donnell preferred to re-pay [sic] his loans on an unscheduled basis and we tried to accommodate his request. When it became clear that he was not voluntarily re-paying [sic] the loans over a reasonable period of time, then I began to move him toward a direction of establishing a more scheduled repayment plan.

⁷The Court takes judicial notice of the fact that banking practice is to post undesignated payments first to interest, rather than principal, reduction.

Question: In follow-up to that then, is the \$426.82 or \$428.82 paid on April 6th what you were hoping to be the periodic payment that you would receive from him on this loan, or is that just the proceeds of some amount of money that he got at that particular point in time?

Ms. Grandy: If you can recall.

Answer: Well, according to the history, it is a scheduled principal payment. Whether or not I was personally satisfied that that was a sufficient repayment plan for the bank at that time, I don't recall. I am making the assumption that I would have preferred that he made larger principal reductions at that time, but was probably satisfied that we had convinced Mr. O'Donnell to at least begin making this amount of principal reduction on it on a scheduled basis.

(Tr. at 41-43.) Clearly then, the bank has not shown by a preponderance of the evidence that it relied on the financial statement in forgoing collection on the first note. Rather, the greater weight of evidence reveals that when the financial statement was tendered and the second loan renewed, the bank was satisfied with, or at least resigned to, the debtor's payment efforts on the first loan.

Moreover, with respect to the bank's renewal of the second note, the bank has failed to prove that the financial statement was materially false. "Material falsity has been defined as 'an important or substantial untruth.' A recurring guidepost used by courts has been to examine whether the lender would have made the loan had he known of the debtor's true financial condition." In re Bogstad, 779 F. 2d 370, 375 (7th Cir. 1985) (citations omitted). See also In re Niemiec, 60 B.R. 737, 740-41 (Bankr. N.D. Ill. 1986) (adopting same test of material falsity).

The bank contends that had it known of the unsecured debt in excess of \$400,000 which the debtor omitted from the financial statement, it would not have renewed the \$25,000 loan on April 1, 1989. However, this argument finds no support in Mr. Cashner's testimony. Mr. Cashner testified as follows concerning the materiality of the omission:

Question: Was there anything in his financial statement that you relied upon that would have caused the bank not to take any collection action at that time?

Answer: I was concerned that Frank O'Donnell was continuing to be delinquent, and I wanted to specifically learn about his sources of cash flow, his continuing obligations concerning all of his direct liabilities, and potential obligations under contingent liabilities. We spent a great deal of time putting together this financial statement making sure nothing was forgotten. We were prepared to give him more time to re-pay [sic] these debts, but at some point in time, if he wasn't able to keep himself current, I was concerned about the unsecured nature of this note. We were also concerned that the collateral did not fully secure the larger note. I was concerned about my position relative to other creditors and what ability I would have in the future to collect a deficiency from Frank O'Donnell.

Question: Did that financial statement give you any reason to believe that you would be able to collect a deficiency?

Answer: After going through this statement, it shows that assets exceed liabilities by over \$1,300,000 on total assets of \$1,800,000. So it clearly showed that there was a significant margin between his assets and liabilities, which communicated to me that Frank O'Donnell could comfortably re-pay [sic] the debt to the bank.

. . . .

Question: Mr. O'Donnell listed on his

bankruptcy Schedule A-3 approximately \$440,000 in unsecured debt which do not appear to appear on that financial statement.

Question: It would have made a difference to you if he had included \$440,000 worth of unsecured debt at the time you reviewed that financial statement marked as Exhibit Number 5?

Answer: Yes.

Question: Why is that?

Answer: Well, at that point, if we would have accelerated the repayment of the debt in question, we would have had a higher likelihood of collecting that debt versus allowing him to continue to accumulate more debt and giving other creditors more time in securing the available assets of Frank O'Donnell versus pledging those assets to Landmark Bank.

Question: In your conversations that you have stated you had with Frank O'Donnell to collect this debt due to the fact that he was continually delinquent in making his payments, although payments are reflected in his history, did you, in fact, request Frank O'Donnell to give you a financial statement of the type in Exhibit Number 5 which is the bank form one?

Answer: Yes.

Question: And is it accurate to say that based upon your review of that financial statement, you felt that in the event Frank O'Donnell totally quit making payments, there were assets available to recover this loan from?

Answer: Yes.

. . . .

Question: Is it fair to say from your conversations with Mr. O'Donnell that at the time you took this financial statement in 1989, you felt he may have had trouble paying some of his other debts as well?

Answer: It was a concern that I had.

Question: But you were comfortable with his assets on the financial statement, is that

correct?

Answer: Yes. His financial statement exhibited the ability to meet all of his obligations in the long run.

(Tr. at 14-15, 16-17, 68-69, 71)

Notably, although Mr. Cashner testified that he took comfort from the debtor's financial statement in deciding to renew the second loan, he never testified that he would not have renewed the second loan had he known the true state of affairs. In fact, even with the inclusion of the additional debt of at least \$400,000, the debtor's net worth on the financial statement still would have been approximately \$955,470. The Court finds it incredible that the bank would have refused to renew a \$25,000 loan to a long time customer with a net worth of this magnitude.

See Order entered this date.

/s/ Kenneth J. Meyers

U.S. BANKRUPTCY JUDGE

ENTERED: February 24, 1994